



December 9, 1965

Letter 308

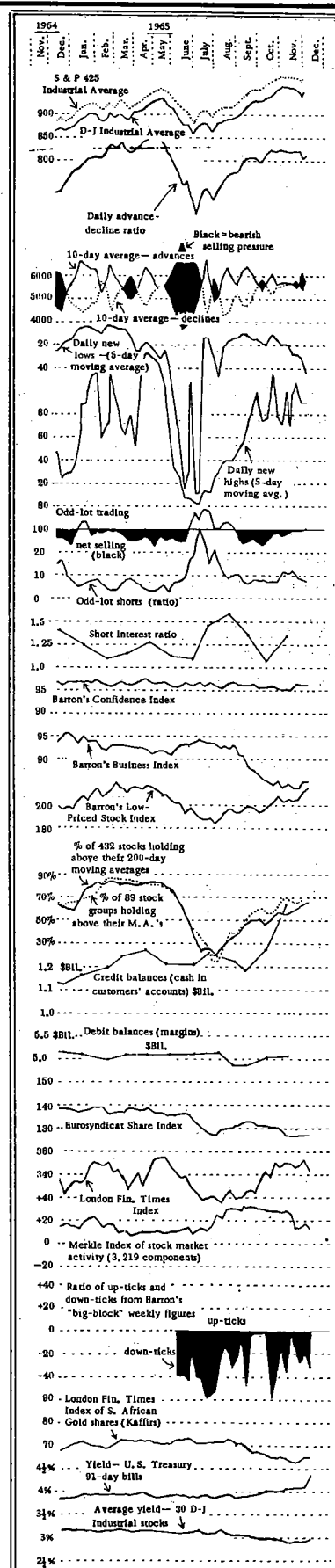
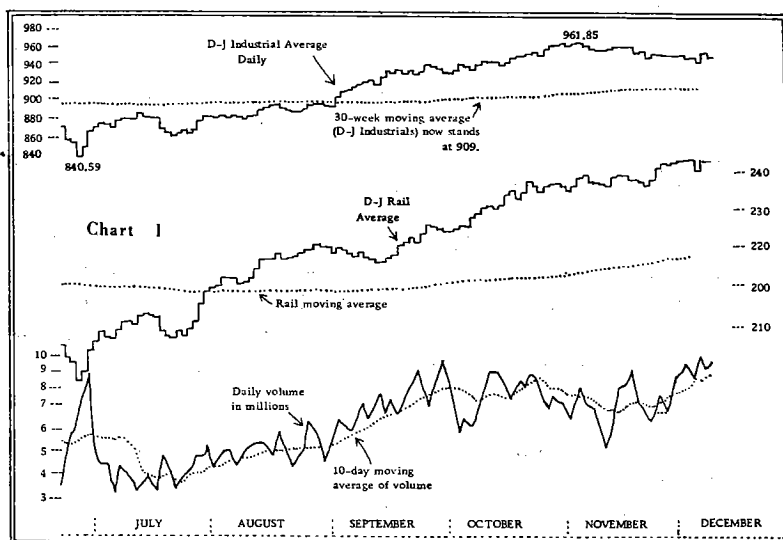
THE MARKET: New subscribers often express surprise at the widely varying discussions which appear in these Letters. Thus in a single issue (for instance, last week's mailing) such diverse studies as the trend of the Averages, a potential broadening formation, foreign markets, the auto stocks, the short interest, Secretary McNamara, etc. are all included. The question might well be asked: "Since under Dow Theory the action of the Averages is conceded to discount everything, and since you call yourself Dow Theory Letters, why bother to discuss anything but the implications of the Averages? Aren't you introducing a lot of extraneous matter which has little or nothing to do with Dow's Theory?" The answer is that I always try to give greatest prominence to what the Averages are saying. And underlying everything I write is an awareness of whether the Averages are tracing a major bull or bear trend.

Thus, despite any speculation to the contrary, Dow Theorists have continued to classify the primary trend of the market as bullish. The reason is simple. On October 11 the Industrials and Rails bettered their May peaks, thereby reconfirming the primary bull trend. Until evidence to the contrary is produced, the primary trend will be taken to remain bullish.

On November 3 Industrials rose to an all-time high of 961.85. Following that date the two Averages entered an extended period of divergence with Industrials retreating and Rails pushing to successive new highs. On December 6 (in response to the discount rate rise) Industrials sagged to a two-month low of 939.53. Rails, however, failed by a wide margin to confirm on the downside (see Chart 1). On December 7 both Averages rebounded strongly, Industrials surging more than 11 points. Whether the "discount rate scare" served to cleanse the air and whether the two Averages are now ready to advance to new highs again remains to be seen. But we do know that the secondary trend has remained bullish; it will continue to be classified as bullish as long as Rails refuse to confirm Industrials on the downside (a downside Rail confirmation, as stated in recent Letters, would entail a move by Rails into the 235 area).

All of which underscores the usefulness of Dow's Theory and the study of the Averages. Veteran market practitioners learn early in the game that it is perfectly legitimate to form opinions and preconceived notions about "what the market is going to do." But unless you want to swap your Madras shirts for rags and patches, you had better wait patiently until the Averages spell out the final story.

The Composite Chart shows the two leading industrial averages near their highs, but a factor to consider is the persistent refusal of the A-D ratio to better its own May high. New lows have expanded to the 45 area, but many of these are preferred issues which have been going down in response to rising interest rates. Barron's Low-Priced Stock Index is at 217, within a few



Page 2 points of its high for the year.
Bulls note that historically the
L-P Index has topped out well
ahead of the Industrials. The percentage of
stocks holding above their 200-day moving
averages has climbed to 66%, a new high for the
move. The London stock average has tumbled
from its high of a few weeks ago, due to definite
signs of slackening in the British economy (auto
sales are now dropping sharply). Barron's big
block transactions show a minus 33 for the week
ending December 3. With the yield on 91-day
Treasury bills now at a high of 4.33, the spread
between the bill yields and the yield on the Dow
is a record 1.34, greatest in history. Any rise in
the Dow from here will obviously increase this
spread, and so the adverse yield spread becomes
a "built in negative factor."

Conclusion: The only hints of potential danger
in the market itself are the laggard A-D ratio
and fact that the Averages have not as yet
established new highs. All of these problems
could shortly be eliminated by a continued
advance. The bearish factors are the monetary
and stock-bond relationships. The overall
picture calls for caution.

PERSPECTIVE: The market has had a good
many worries to contend with. There is the
expanding war in Vietnam, the possibility of
price controls, exchange controls, a new gold
outflow. There is the reality of a fat increase
in the discount rate, a rapid tightening of
money rates, a slumping bond market and a
sagging Utility Average.

Yet despite all this, despite huge exchange
volume and despite obvious speculation which
has been labeled "dangerous" by many, the
market has refused to decline importantly.
Isn't this a sign of real strength? The answer
is that it may well be. In the face of all the
aforementioned troubles, one can, in fact,
document a good case in favor of the bulls.

Nevertheless, my own guess is that the whole
area since May, 1965, will probably go down
in the record book as part of a major top. It should be remembered that sudden reversals such as the one which occurred at the May
peak are usually followed by lesser declines. The major drops, such as that of 1962, have been preceded by many months of
divergent or deceptive action with much backing and filling, unconfirmed new highs, etc. I suggest that subscribers study the
paragraphs below and thereby test their own instincts and "advance vision" against time.

(1) The market cycle and the business cycle are now seven months older than they were last May, but the fact is that little has been
accomplished by the wide-swinging Industrial Average since that time. The period since the May, 1965 Industrial peak has been
characterized by the heaviest trading volume in N.Y.S.E. history. Between May and June the Industrials dropped 99 points; they
subsequently regained all their lost pointage and then pushed 2.6% above their old May high. Currently, Industrials are still
whipping about within the May-October range. In other words, during the entire seven month period Industrials have gained little
or nothing on balance.

(2) Other compositions such as the Utility Average, the various bond averages and the advance-decline ratio are now below their
earlier May peaks. Only the Rail Average has managed to produce a substantial gain above the old May high. The net result of all
this activity can hardly be termed impressive. It does, in fact, suggest investment liquidation.

COMMENTS: The more powerful the government, the greater the impact of its politics on the
psychology and economy of the nation. It is well to remember that less than a year ago dazzled
commentators were referring to the President as "super-Lyndon," and this in only half-jest. The
President seemed to have the entire nation on strings, and nary a senator or an agency that would not
dance to his tune. This breath-taking show of strength fascinated the country, and it lent credence
to the thesis that an all-powerful Administration "wouldn't let anything go wrong" in the market
place, the nation or the world.

But it is most interesting to note the change which is now enveloping the Administration, a change
still not recognized by the average citizen or investor. L.B.J. has been losing "control" on many
critical fronts. (1) The Vietnam war has ballooned out of all proportion, dwarfing anything that was
foreseen or hinted at even a year ago. The war is "run" by McNamara, with Johnson appearing to be
waiting anxiously on the sidelines. (2) The blissful honeymoon between L.B.J. and business has been
rudely jolted by the clampdown on prices. The Administration still tries to hold hands with businessmen,
but the trust is not really there anymore; it has been replaced by fear and suspicion. (3) The illusion
that L.B.J. had all the government agencies in the palm of his hand is shattered. The Reserve Board
raised the discount rate, and thereby took its stand despite almost daily Administration announcements
to the effect that "there is no need for any rise in interest rates." Anyone who has studied markets knew
that the discount rate rise had to come, but the "shock" came from the realization that the old
"super-Lyndon" image was only a dream.

From calls received here, I gather that many are hoping that the discount rise to 4½% will magically
cure the U. S. balance-of-payments problem. It will not. To the extent that it holds back inflationary
forces, the rise in rates will help. But the major problem is the U. S. monetary printing presses. As
long as the money supply is expanded, some part of the new flood of dollars is bound to find its way
to foreign shores (and thus build up new gold claims against the dollar). Concern about the continued
deficit is expressed in the latest issue of the influential Cleveland Trust Company Business Bulletin.
The language used here is extremely strong, considering the source: "As long as unemployment remains
above the 4 percent rate, according to current fiscal standards, a continued deficit is desirable. And
as long as prices are not rising rapidly it is not dangerous. But since unemployment is now down almost
to 4 percent and prices are rising the economy will require a smaller deficit in 1966 than 1965, even
by the standards of the new economics. If a smaller deficit is not forthcoming in 1966 it will not be the
fault of the 'new economics' but of an unwillingness to play the game even by the new rules."

In Letter 305 I discussed what I termed "the final phase of the 19-year bear market in bonds." Many
subscribers, as they glance over current bond quotes, are beginning to understand what I mean. But
few realize that world business is now
facing the greatest bond market
competitor of all times, the U. S.
Government. With its giant \$327

billion in debt which must be
serviced and refinanced, with its
insatiable appetite for new spending
projects, the U. S. Government is
casting its shadow darkly over money markets throughout the world. And this at a time when the business
world itself is scrambling for money for expansion, when a consumer goods boom is being financed by
mountains of credit and when the U. S. is fighting an expanding war in Vietnam. In short, the money
market's all over the world are beginning to "talk." If you think it's any easier to borrow overseas,
then read this little squib from the latest Business Week (December 4, as shown above). In this
observer's opinions, we are witnessing one of the most fascinating periods of potential monetary and
credit trouble in modern history.

The rush by U.S. companies to sell bonds overseas
Oct.2'65,p107] is beginning to have its impact on Euro-
pean financings. A \$20-million issue by Ireland has been
canceled because American bond sales—close to \$300-
million in the past few months—have congested the
European capital market. Latest: General Electric, Fed-
erated Department Stores, and a \$30-million IBM issue.

My wife and I had the pleasure of a weekend visit from Mr. Harry Schultz and his wife. Schultz is
the greatest world traveler I know, and his international market letter is apt to be written from London
one week, Lisbon the next. Our views on the market are not far apart, as are our views on the pleasures
of beating inflation. One excellent way to beat inflation is to dine in Mexico, 20 miles south of this
office. This all four of us did, and price amused the Schultzes no end. Cost for four lunches, with beer
or coffee ... \$1.65 (of course, you have to like Mexican food, which, I might add, we do).

(3) Since the May peak of 939.62, the banking figures have shown steady deterioration. The authoritative Bolton-Tremblay Bank Credit Analyst gave their first bearish "signal" in June, 1965. In the latest issue of the Analyst, Mr. Bolton lists the 10 "sell signals" which have been given according to his methods. These signals occurred in 1919, 1923, 1929, 1937, 1940, 1946, 1951, 1955, 1959 and June, 1965. The signals of 1923 and 1940 occurred somewhat after the final peak in the Dow, but all the others occurred at varying intervals prior to the peak in the Industrials. The average lead time for these signals was slightly less than 6 months. The longest lags (1951 and 1955) were eight months. The current month of December will mark the sixth month following Bolton's bearish June signal. We would appear to be pushing further and further into the "high risk" area.

(4) From a Dow Theory standpoint, the price action of the Industrial and Rail Average as detailed in the last Letter is now becoming "suspicious." Industrials struck their all-time high on November 4, over one month ago. Since that time Rails have climbed to successive new highs, but Industrials have (so far) failed to confirm. Such action in the past has frequently indicated distribution. Robert Rhea noted that when divergence occurs during or after an extended and excited primary movement, such action is often a prelude to a secondary or a primary reversal.

(5) The psychology of today is the type which is often associated with a major top. People are strongly influenced in their "feelings" by the recent past. Because the recent past has been characterized by a business boom, the almost unanimous opinion seems to be that next year will produce "more of the same." This view is being reinforced by Vietnam, and the feeling that "things can't slacken while the war is on." The possibility of a profit squeeze, exchange controls, a let-up in consumer buying or a period of inventory liquidation are generally ignored.

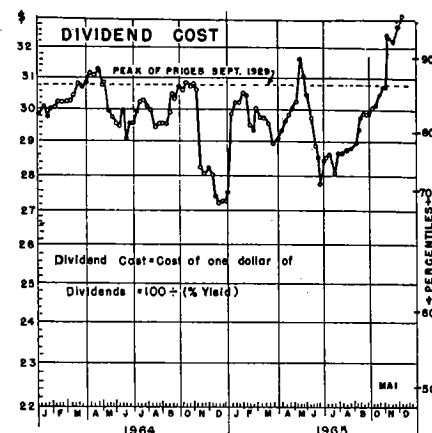
VALUES: There are a great many ways of expressing "values" in the stock market. Some analysts examine stocks on the basis of price-earnings ratio. Some study bond-stock yield comparison, others prefer historical stock yield comparisons.

One of the most interesting of these studies is presented by Merrill Analysis, Inc. (Box 228, Chappaqua, N.Y. 10414). Merrill runs a chart showing the "cost of a dollar of dividends" (based on dividends on the D-J Industrial Average). This study is actually a variation of the yield-on-the-Dow method, but the cost of a dollar of dividends presents the case a little more dramatically. To obtain his cost of a dollar of dividends statistics, Merrill divides the figure 100 by the average yield on the Dow.

Merrill's chart shows that the cost of dividends has "taken off" in the latest period. The conclusion is obvious; when, after a three year market advance and a five year economic boom, investors and speculators are willing to pay almost \$33 for a dollar of dividends, they are exhibiting an abnormal amount of enthusiasm towards the market.

As an added point of interest, Merrill Analysis shows a percentage scale on the right side of the chart. This scale groups all dividend tabulations since 1929 in relation to frequency of occurrence. For example, we note on the chart 50% of all dividend-cost points occurred at about \$22.50, so that we might call the \$22.50 level the "average" historical price for a dollar's worth of Dow dividends. Again we note that 80% of all points since 1929 were below \$29.50. Finally, we note that better than 90% of all points since 1929 were below \$31.75. Conclusion: the current \$32.75 per a dollar of dividends is a rarity, judged by past history. It is, in fact, well above the peak prices of September, 1929 (see chart).

The accompanying newsclip provides a glimpse of another rarity — the other side of the yield coin. Not only are common stocks offering thin yields but simultaneously Government bond yields have climbed to the highest yields in a generation. Subscribers with balanced portfolios are beginning to understand why I have been insisting that cash be placed in short-term Treasury bills, not Treasury bonds. This advice remains unchanged.



Treasury Bond Yields Highest Since Mid '20s

NEW YORK —(AP)— Bond prices dropped sharply last week as pressure mounted in the money markets for higher interest yields, despite government pleas to keep interest rates down.

U.S. Treasury bond prices dropped across the entire list. The price declines pushed yields on 14 issues to 4.5 per cent or more—the highest since the mid 1920s.

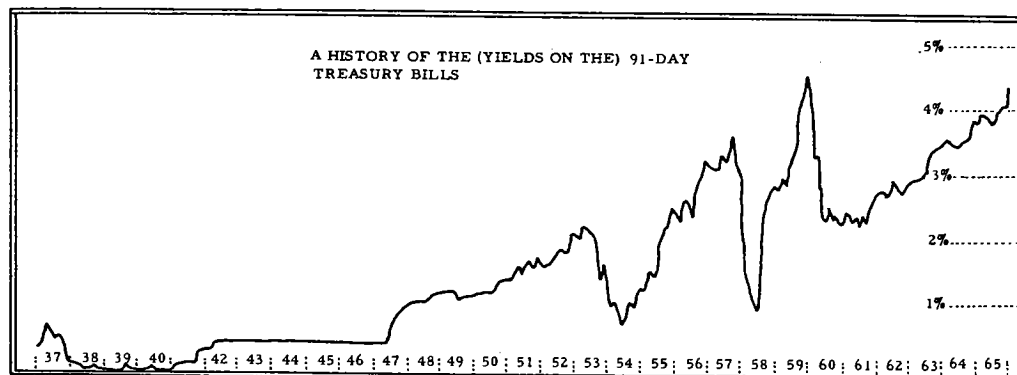
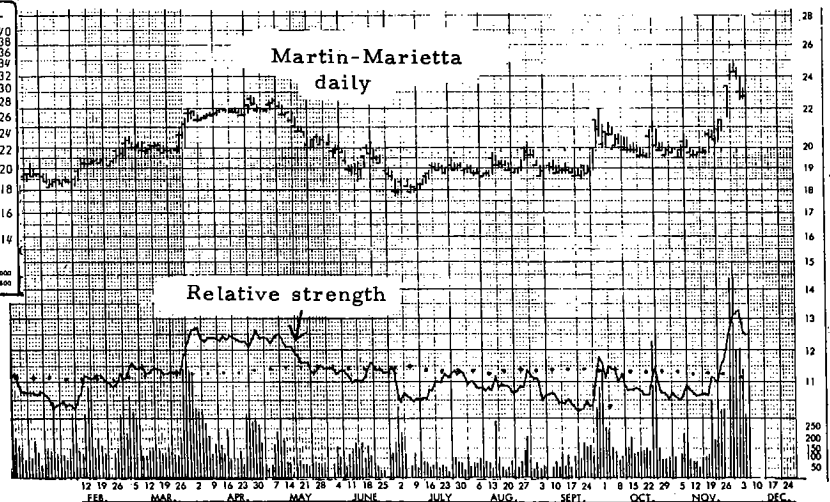
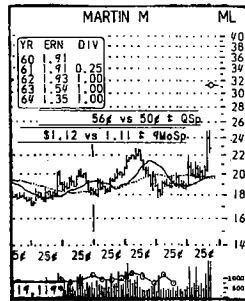


CHART OF THE WEEK: The accompanying chart of Treasury bill yields from 1937 to date is interesting both from the standpoint of history and from the standpoint of practical investing. As the chart so dramatically shows, the

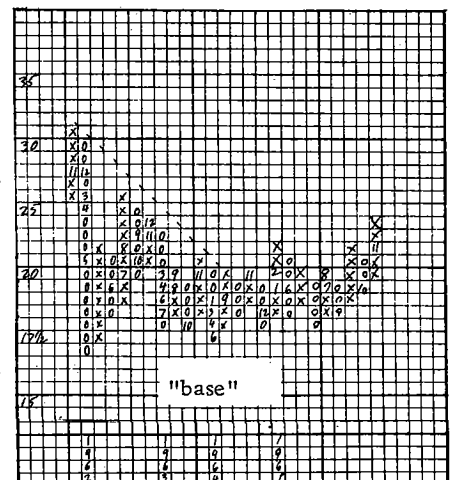
Page 4 bills are now providing the biggest bargains in income in a generation. Only once before did the bills hit the 4.3% yield area, and that was in late 1959 to early 1960, just as Wall Street was staggered by the issuance of the famous "Magic Fives" (five year Treasury notes yielding 5%). Conclusion: investors are now being treated to rare bargains in fixed-income instruments. My advice: place your spare cash in 91-day Treasury bills, which may be purchased through your bank or broker. Place standing orders to "roll over" (i.e., renew) the bills every 91 days or at maturity.

STOCKS: Back in Letter 294, based on the technical position of the individual stocks and my estimate of where this nation was headed, I recommended purchase of four aircraft stocks, Lockheed, Northrup, Boeing and McDonnell. Prior to that in Letter 286 I had recommended Ling-Temco at a price of 26 (on the basis of a huge base and a rising relative strength pattern). My opinion of where this nation is heading has not changed since Letters 286 and 294. However, I want to discuss one more aircraft which is now in a buying range based on the technical approach.



The stock is Martin-Marietta. Following is the technical checklist which I use for selecting a stock. (1) Is ML in the right stock group? Yes, Aircraft is one of the strongest groups on the Board. (2) Any insider or fund buying in ML? Nothing in the last 30 days. (3) What about odd-lot buying or selling? Odd-lotters have been steady sellers of ML for months, a bullish indication in view of the rising trend of ML since June (if odd-lotters have been selling and the stock has been rising, presumably bigger money has been buying.) (4) Is the stock technically bullish? Yes, as seen on the point & figure chart, ML gave its most recent bullish signal when it touched 23, thereby bettering a double top at 22. (5) Has ML a large enough base to support a substantial move? Yes, ML is one of the last aircraft stocks to "break out," and the base going back to 1962 (see P & F chart) provides a "price objective" of 34. (6) How is ML in relation to its 200-day moving average; has it moved too far already? No, ML is only 3 points above its moving average (see small weekly chart). (7) What is the relative strength (RS) picture on ML? Good, note the daily chart and the rise in RS to the highest point of 1965.

MARTIN-MARIETTA (ML)



A few weeks ago in Letter 306 I drew attention to Minnesota Mining & Mfg. I noted that following a five year drop in relative strength, this stock appeared to be turning the corner (please refer to chart in Letter 306). I also noted the strong "double bottom" in MMM and stated that the breakout would come in the 66-68 area. The daily chart of MMM is a valuable study in relative strength (RS). Here we see the reversal in RS in September and the manner in which the RS has formed a beautiful rising trendline. The stock is now acting better than the market on good days and bad, which is a characteristic of improving RS. Last week MMM rose above 70 for the first time since 1963. This high-grade equity appears to be making a fundamental turn for the better. The reason for the turn will probably be known weeks or months from now. If you want to speculate, this stock still appears attractive.

Large daily charts of MMM and ML courtesy of Traders Research, 1431 Pearl Avenue, Alton, Ill. 62003 P & F chart of ML courtesy of Chartcraft, Larchmont, New York.

Small weekly chart of ML courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.

QUOTE OF THE WEEK (From editorial, N.Y. Times, Dec. 3). "It has always been clear that escalation of the war by one side could bring about escalation by the other, which in turn be followed by further escalation, leading possibly on to war with Communist China and/or a third world war. Even now, the Vietnam war is becoming exactly what President Eisenhower, Kennedy and Johnson have all wanted to avoid; a land war in tropical jungles by white men against Asians."

